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February 21, 2003

The Honorable Pat Wood, III
Chairman
Federal Energy Regulatory Commission
888 First Street, N.E.
Washington, DC 20426

Dear Chairman ~~Wood~~: Pat

The undersigned Public Utility Commissioners holding office in various southeastern states hereby respond to your request for input on how our states and the Federal Energy Regulatory Commission (FERC or Commission) can work together to advance competitive wholesale electric markets in our region for the benefit of ultimate consumers – a goal we trust that we share with the Commission. We have discussed among ourselves the issues arising from the Standard Market Design (SMD) Notice of Proposed Rulemaking (NOPR) and the formation of regional transmission organizations (RTOs) within the region and have concluded that an incremental approach to voluntary RTO formation and wholesale market development which ensures that the benefits for retail customers outweigh the costs and that the existing jurisdictional responsibilities of state and federal regulators remain intact is the best way to proceed to improve wholesale markets in the Southeast.

As regulators in states where there is still a retail electric service obligation and a pervasive reliance on a traditional industry structure mandated by state law, we have a clearly defined legal obligation to protect the retail customers of the investor-owned utilities that provide service in our states – a responsibility that we cannot and will not abdicate to federal regulators. Acceptance of any alteration in the manner in which electric power is provided at wholesale or retail that would have the impact of increasing the cost of retail service or decreasing the reliability at which retail service is provided, without proven and quantifiable offsetting benefits, would amount to such an abdication of our responsibilities to the retail consumers that we are obligated to protect. Given all of the factors recited below and our state law obligation to protect the rates and quality of service provided to retail consumers, we believe that an incremental approach to instituting any changes in the manner in which electric power is provided at wholesale and retail in the Southeast is the best way to proceed.

The reasons that justify the need for an incremental and voluntary approach to market reform in this region have been discussed before, but bear repeating here. First, our electric supplies are among the least costly and most reliable in the nation. We have sufficient generation for the foreseeable future. We are aware of virtually no major transmission bottlenecks that result in cost or reliability problems for our consumers. The investor-owned utilities, municipal systems, and electric cooperatives that serve our citizens are financially sound and have sufficient economic strength to provide needed infrastructure to meet future demand. In other words, there is no crisis requiring abrupt action in the Southeast. [1] Second, there is little or no retail access in the region, so that the vast majority of the companies we regulate remain vertically integrated. The principal benefit of wholesale competition in our states is in providing an additional option to our regulated utilities for meeting incremental generation needs, as compared to a self-build option, via competitive procurement under long-term contracts and through short-term economy and reliability purchases. Utilities under our jurisdiction have an obligation to meet consumer needs at the lowest reasonable cost, and we set generation adequacy requirements to ensure that sufficient capacity is available to meet the needs of the customers they serve. Thus, we do not depend on the wholesale market to the same extent or in the same manner as is the case in states with retail access. Moreover, in some of our states our utilities are "long" on self-owned generation capacity and only procure an incidental amount of generation on the wholesale market, primarily for peak power supplies.

While we acknowledge that we should always strive for improvement in the way in which electric power is delivered to retail customers in the Southeast, both our regulated retail markets and wholesale competitive markets seem to already be working well for the benefit of retail consumers. This fact suggests the need for further caution in attempting to implement major changes in regional electric power markets. Because of these factors, there remain significant doubts in the minds southeastern regulators about both the benefits of any scheme that would materially change the provision of electric service in the Southeast. These doubts seem to be shared by many in the public power and rural cooperative communities as well. The recent cost benefit study performed at the request of the Southeastern Association of Regulatory Utility Commissioners (SEARUC) by Charles River Associates (CRA); the recent Notice of

[1] Note that while restructuring in Virginia has already altered the "traditional industry structure" and retail rates have been unbundled, electric service in Virginia continues to be provided, with few exceptions, by financially sound vertically integrated electric utilities with virtually no retail competition. Moreover, the General Assembly has just approved legislation in its 2003 session (HB-2453) that will prohibit Virginia utilities from transferring ownership or control of transmission assets to RTOs prior to July 1, 2004. Further, not all of the background conditions described in this paragraph strictly apply to Virginia. However, there is no crisis in Virginia requiring abrupt action.

Proposed Policy Statement entitled "Proposed Pricing Policy for Efficient Operation and Expansion of Transmission" issued on January 15, 2003; and your recently-entered Entergy and SMEPA orders, requiring the rolling-in of certain costs associated with the interconnection of several merchant generators to the transmission system, have only exacerbated these concerns.

The undersigned Commissioners are encouraged by your announcement of January 13, 2003, that the FERC will issue for further comment a white paper in April concerning modifications to the FERC's SMD proposal, and your suggestion that regional flexibility and regionally tailored timetables are now your preferred approach. We take this as an important signal that you intend to work with us on an approach to addressing an institutional change to the manner in which electric power is provided in the Southeast that is moderate, incremental, and tailored to our particular regional needs and characteristics. Such pronouncements must, however, be accompanied by actions. Mere words, no matter how well intentioned, will not suffice to allay the genuine concerns about the potential impact of RTOs and SMD upon the quality and cost of electric service in the Southeast. The only way to alleviate these concerns is for the FERC to actually modify the current SMD proposal so as to recognize the distinct characteristics of the Southeast and to avoid injuring the very consumers that we both believe should be the beneficiaries of any proposal.

In the spirit of suggesting what might be included in the white paper to be issued by the Commission, we will discuss in the remainder of this letter some of the threshold issues that the Commission must address in order to facilitate such an incremental, cooperative approach to electric industry improvements in the Southeast. More particularly, in order to avoid injuring consumers in the Southeast and to have any hope of obtaining the support of Southeastern state commissions, the FERC should include the following items in the white paper that it intends to issue as part of the SMD process:

1. ***States that have not implemented retail access must retain jurisdiction over retail transmission service to ensure their continued ability to protect retail consumers. This means that the Commission must not assert jurisdiction over the transmission component of bundled retail services, including related transmission planning and generation resource adequacy issues.***

2. ***Native load customers, including customers of investor-owned utilities, cooperatives, and municipal systems, who have paid for the existing transmission system in their rates, must retain the same (or equivalent) rights to use the transmission system as they have today and should not be burdened with any significant additional costs, now or in the foreseeable future. This includes preservation of the existing native load priority and the immediate implementation of participant funding.***

3. ***Cost shifts between regions or among customers within a region must be avoided. Implementation of any RTO or new market design in the Southeast must ensure that no customer or class of customers is forced to assume costs now borne by other customers.***

4. ***RTO formation should be voluntary and supported by evidence that the costs of RTO formation and operation, including the impact of locational marginal pricing, are outweighed by the resulting benefits. In addition, the authority of certain state commissions over the transfer of ownership or operational control over transmission assets should be recognized, so that all parties, including the FERC, recognize that RTO formation is contingent upon state as well as federal regulatory approval. The requirement for state approval must not be dependent on whether a utility has bundled retail rates.***

5. ***Any final SMD rule must allow regional flexibility and be consistent with the above threshold principles. We believe that the Commission should ultimately issue guidelines on what constitutes the objectives and necessary minimum functions of RTOs and market design and leave it to the regions to meet the objectives and minimum functions. The Commission should not develop inflexible rules that may discourage states from moving forward. While this may sound similar to the Commission's approach in Order No. 2000, we continue to believe that it is the right approach and will result in the development of institutions and markets that meet the Commission's objectives without substantial litigation.***

We believe that commitments are needed from the Commission on these threshold issues in order for us to proceed to the next step, which should be detailed discussions between the FERC, the state commissions, and stakeholders in the region for the purpose of attempting to agree upon the contents of any RTO and SMD rule that the FERC may choose to adopt. Commitments by the FERC on these threshold issues are necessary to ensure that we as state regulators will be able to carry out our duties to protect electric consumers in our states and to ensure that our shared goal of reliable service at the lowest reasonable cost is achieved. Without commitments on these issues, we will continue to have concerns about the development of standard market design and related proposals in this region. In the remainder of this letter, we discuss in more detail the commitments that we are seeking as a foundation for cooperatively developing appropriate modifications to the structure of the electric industry in the Southeast.

1. Retention of State Jurisdiction

We strenuously object to the Commission's assertion of jurisdiction over the transmission component of bundled retail rates and service in the SMD NOPR. We do not believe that the FERC can ever assert jurisdiction over this component of electric service because the transmission component of bundled retail service is neither interstate transmission nor the sale of electricity at wholesale. The Commission's primary legal basis for the proposed SMD rule is its assertion that utilities have discriminated against wholesale customers by virtue of their compliance with state laws requiring preferential service to retail customers who have paid for the construction and operation of the transmission system through their retail rates. This finding by the Commission and its conclusion – that, as a result of this alleged discrimination, it must assert jurisdiction over the transmission component of bundled retail service – is unsupported by adequate evidence and is wrong as a matter of law and considerations of sound public policy. We also have significant concerns about other assertions of jurisdiction by the Commission in the SMD NOPR, including, but not limited to, its assertion of jurisdiction over resource adequacy and transmission planning issues. While we could spend years arguing about these questions in the Courts and in Congress, a better course of action would be for us to agree to retain current jurisdictional boundaries as outlined in Order No. 888 and to work cooperatively to implement a system for providing electric power to wholesale and retail customers that provides for increased wholesale competition while protecting retail consumers. As part of this process, any such approach must be shown to have net benefits to retail customers as is required by existing state statutes governing the transfers of ownership or control of utility assets. Thus, the first commitment we need from the Commission is an agreement that it will not assert jurisdiction over bundled retail transmission rates and service, transmission planning, and generation resource adequacy as proposed in the SMD NOPR.

2. Protection of Native Load Customers

The development of a modified structure for providing electric service in the Southeast can only obtain state commission support where native load customers (a group that includes the retail customers of vertically-integrated utilities, municipal distribution systems, and rural cooperatives) continue to have the right to use the transmission capacity (that they have paid for in rates) in the future in essentially the same way that they have used that capacity in the past without the incurrence of significant additional costs. It would be unfair to the citizens of our states and amount to a shirking of our responsibilities as state officials to approve changes in existing institutions that place these consumers at risk of increased costs and less reliable service without a showing (that has not yet been made) that these customers would receive offsetting benefits stemming from the proposed changes.

The specific SMD issues that are implicated by this condition include, but are not limited to: the ability for load-serving entities to continue to reserve sufficient transmission capacity for native load requirements, either through physical rights or equivalent financial rights, including growth; the phasing-in, if instituted at all, of locational marginal pricing; the permanent allocation of any financial transmission rights (or congestion revenue rights) to existing native load, including an appropriate reservation of FTRs or CRRs associated with native load growth; and the ability for utilities with load-serving obligations to continue to reserve a capacity benefit margin. There are, of course, planning implications as well. Assurance that retail customer costs are not significantly increased as a result of any change in the manner that electricity is provided in the Southeast is primarily dependent on three factors identified by the cost-benefit analysis commissioned by SEARUC and performed by CRA: first, minimizing the start-up and on-going costs of any RTO or similar institution determined to be appropriate for the region, and assigning those costs to the beneficiaries of any approved industry changes in an appropriate manner; second, the immediate availability of participant funding for interconnection and transmission expansion costs in the region that ensures that customers only have to fund upgrades from which they benefit; and third, the assurance that congestion costs not previously charged to retail customers are not imposed solely as a result of any new market design. There are of course additional details of any new regional institutions that can affect retail consumer costs that will also need to be worked on in our proposed future discussions. We seek here the Commission's commitment that it will work with us to preserve the existing rights of native load customers and to avoid the adoption of any rule or policy that would increase costs to retail customers, along with the assurance of an immediate shift to a policy of participant funding so that ratepayers in the Southeast are not forced to bear the burdens associated with the Commission's existing policy of rolled-in pricing, pending the implementation of such policy changes as are ultimately deemed appropriate for the Southeast.

3. Avoidance of Cost-Shifting

Implementation of industry changes in the Southeast must not result in any significant cost-shifting between regions or between consumers within the region. Cost-shifting can be another effect of RTO formation or other industry changes that could increase retail customer costs. Some examples of proposals found in the SMD NOPR that would likely result in significant cost shifts in the Southeast include the proposed transition over four years from license plate to postage stamp rates; the elimination of through and out (export) rates which would shift costs from wholesale to retail customers; and the implied prohibition on the recovery (during a transition period) of lost revenues due to the elimination of rate pancaking within an RTO. We seek the Commission's commitment that it will not impose requirements that result in any significant cost-shifting to the retail and other native load customers in our states.

4. Voluntary RTOs and Recognition of Joint Jurisdiction Over RTO Formation

Until the issuance of the SMD NOPR, the Commission had supported the implementation of RTOs on a voluntary rather than a mandatory basis. Most southeastern state commissions supported this approach, because of significant concerns about the extent of the Commission's legal authority to compel the formation of RTOs and because of concerns that the costs of RTO formation and operation might outweigh the benefits of independent transmission operation in some or all of the Southeast. Southeastern state commissions recognize that the ability of vertically-integrated utilities to purchase power from a wider range of suppliers could have benefits for retail customers. On the other hand, we also recognize that the creation of an RTO introduces an element of inefficiency into the operation of a vertically-integrated utility system and requires the incurrence of significant additional costs. The results of the SEARUC cost-benefit study suggest that the cost/benefit concerns expressed by many southeastern state commissions are potentially meritorious. For example, the benefits of RTO formation do not appear to outweigh the costs in the Carolinas under any of the scenarios examined by CRA.

Following the issuance of Order No. 2000, voluntary RTO formation was ongoing in much of the Southeast. For example, the Commission had given preliminary approval to the GridSouth RTO. Similarly, the Florida Public Service Commission has done much work toward facilitating the approval of GridFlorida.[2] As the Commission is aware, considerable work has been done in an effort to further the formation of the SeTrans RTO. Under that set of circumstances, it is not fair to say that there has been no movement in the Southeast toward RTO formation prior to the issuance of the SMD NOPR. It is, however, fair to say that there is considerable concern that the Commission's efforts to facilitate the creation of a competitive wholesale market have failed to adequately consider the distinctive characteristics of the electric industry in the southeastern United States and that the adoption of the measures proposed in the SMD NOPR (including mandatory independent operation of the transmission system) may be harmful to retail customers in the Southeast. Of particular concern is the potential impact of locational marginal pricing. The implementation of such a pricing regime should not be imposed on states but should only be implemented if and when individual states recognize benefits and agree to the change. The ultimate decision as to whether the formation of an RTO is in the best interests of customers in a particular area should be a combined decision between the FERC and the relevant state commissions. For this reason, we believe that one of the fundamental components of any agreement between the FERC and the southeastern state commissions concerning potential improvements in the industry structure in the Southeast is a recognition by the FERC

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[2] Note that the Florida Public Service Commission has found the Grid Florida utilities' pro-active formation of an RTO to be prudent, and has approved the structure and governance of the RTO. Other issues, such as market design and pricing, are pending.

that RTO formation should be deemed voluntary rather than mandatory and that no RTO can be formed in any part of the Southeast without approval of both the FERC and the relevant state commission (to the extent that the relevant state commission has statutory approval authority under state law). Recognition of these two factors should be included in the white paper the Commission intends to issue in April as a precondition for further cooperation between the FERC and the southeastern state commissions.

5. SMD and Regional Flexibility

Finally, we believe that the Commission should issue its final SMD in the form of broad guidelines with substantial regional flexibility built into the process. There are many aspects of the SMD NOPR that we find troublesome, regardless of the fact that many of us support the basic objectives sought to be accomplished by the proposed rule. If the Commission decides to proceed with the basic proposals embodied within the SMD NOPR, it should do so in a way that outlines general principles for the development of truly competitive wholesale markets, but also provides regional flexibility so that innovative institutions can develop to appropriately meet regional needs. Trying to define a single set of market rules that fit the entire nation is neither possible nor desirable. It would make more sense for the Commission to establish the basic guidelines and principles necessary for wholesale markets to work within and between regions, and let the states and the regions work with the Commission to develop the detailed market designs appropriate for each region. Thus, we seek a commitment from the Commission that it will issue the SMD proposal in substantially modified form that addresses our concerns, stated here and in the comments we have filed separately on the proposed rule.

Commitments from the Commission on these five threshold issues will allow us to proceed to the next step, which should be to develop a timetable and work plan for implementation of a regional market design and institutions. As the Commission suggests in its January 13th press release, it may be appropriate for different regions that are at different evolutionary points with respect to retail or wholesale competition to have different timetables for improved institutional development and implementation. We additionally believe that we need to take deliberate steps that develop the confidence of our states and consumers in regional institutions before moving on to full-scale implementation of such SMD concepts as locational marginal pricing, congestion revenue rights, and other aspects of SMD that require substantial time to properly develop and implement (if, in fact, those components of SMD should ever be implemented). If the Commission agrees that such an incremental approach is appropriate for the Southeast, we would commit to sit down with you, agree on the initial steps to be taken, and work out a reasonable schedule for consideration of all of the issues by the states and the FERC.

While we believe these commitments on the part of the Commission are essential for us to proceed to the next step of initiating discussions on the details needed to satisfy all of the above objectives, it is also essential for us to note that our individual commissions will ultimately have to review any proposals submitted to us by our jurisdictional utilities and consider those submissions based on the requirements of our states' laws. None of us can make any commitment to approve any specific market- design component, any RTO proposal, any aspect of SMD, or any other wholesale market-related matter that might come before us in any future proceeding that we are required to consider under state law. Instead, any decision we make in such proceedings would be governed by the legal standards we are required to follow under state law and the evidence of record. We assume that the FERC will also have to ultimately review any specific submissions under its statutory responsibilities and will follow federal law in making any such decisions, so this should come as no surprise to you. But we do pledge that if the Commission is willing to accept the threshold conditions described above, we will work with the Commission, our jurisdictional utilities, and all other interested stakeholders in good faith to develop mutually acceptable industry structure proposals for the region that would benefit the retail customers of our states and that could be considered by our commissions in a timely fashion and implemented in an appropriate manner.

We look forward to hearing your response to our proposals and to beginning the dialogue that could result from a favorable determination on these threshold issues. We are, of course, willing to meet with you individually or collectively to discuss our concerns.

Sincerely,

James Y. Kerr, II, President
Southeastern Association of Regulatory Utility Commission, on behalf of the individual Commissioners listed below.

Alabama Public Service Commission
Jim Sullivan, President
Jan Cook
George C. Wallace, Jr.

Arkansas Public Service Commission
Sandra L. Hochstetter, Chair
Daryl Bassett
Randy Bynum

Florida Public Service Commission
Lila A. Jaber, Chair
J. Terry Deason
Braulio L. Baez
Rudolph "Rudy" Bradley
Charles M. Davidson

Georgia Public Service Commission
David Burgess
H. Doug Everett
Stancil O. (Stan) Wise

Kentucky Public Service Commission
Martin J. Huelsmann, Chairman
Gary W. Gillis
Robert E. Spurlin

Louisiana Public Service Commission
James M. Fields

Mississippi Public Service Commission
The MPSC will send a separate letter to the Commission expressing its position on these issues.

North Carolina Utilities Commission
Jo Anne Sanford, Chair
J. Richard Conder
Robert V. Owens, Jr.
Sam J. Ervin, IV
Lorinzo L. Joyner
James Y. Kerr, II
Michael S. Wilkins

South Carolina Public Service Commission
Mignon L. Clyburn, Chair
H. Clay Carruth
Nick Theodore
William Saunders
James Blake Atkins

Tennessee Regulatory Authority
Sara Kyle, Chairman
Pat Miller
Deborah Taylor Tate

Virginia State Corporation Commission
Hullihen Williams Moore, Chairman
Clinton Miller
Theodore V. Morrison, Jr.

Cc: The Honorable Nora Brownell
The Honorable William Massey
The Honorable Spencer Abraham
Governors of the SEARUC Member States
Southern Governors Association
Congressional Delegations of the SEARUC Member States